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TAXABLE INCOME. CANCELLATION OF INDEBTEDNESS

Most judicial thought regarding the problem of whether a cancellation of indebtedness is to be recorded as income or as a gift to the debtor is traceable to the landmark opinion of the Supreme Court in *United States* v. *Kirby Lumber Company*, decided in 1931.[1] The Court there held that the discharge of bonds by payment of less than the face amount of the obligations resulted in taxable income to the issuing corporation in the year of cancellation. This decision coming at the depth of a great depression, resulted in considerable confusion as to the income tax consequences of cancellation of indebtedness, and placed a heavy burden on corporations seeking to adjust their capital structures. The generally lower market price of securities made the problem significant to every debtor who contemplated improving his balance sheet by purchase and retirement of his own securities, thereby reducing his current interest obligations so as to avert possible bankruptcy. Courts deciding cases of this nature were torn between the *Kirby* decision as precedent, and the precarious financial condition of many of the litigants. As a result, the evolution of legal doctrines in this field was inextricably interwoven with the economics of the depression era, and in order to prevent hardship in particular cases several exceptions were developed to the rule of the *Kirby* case.[2]

One of these exceptions,—*where the cancellation of indebtedness is deemed to be a gift from the creditor to the debtor*—was strengthened, if not established, by the Supreme Court in *Helvering* v. *American Dental Company*.[3] In that case, the taxpayer, a corporation, owed certain past due bills for merchandise. The indebtedness was represented by interest-bearing notes. Interest had been deducted for several years in the taxpayer's income tax returns. The corporation also owed several years back rent which had been accrued as an expense. The taxpayer negotiated an agreement with his creditors whereby he agreed to pay part of the debts and agreed to cancel the remainder. By virtue of this arrangement, the corporation credited the total amount of the cancelled debts to earned surplus, but did not report any of the sum as taxable income. The Commissioner thereupon increased the taxpayer's income to the extent that the items of indebtedness had been used as deductions to offset income in like amounts in prior years.

The Board of Tax Appeals affirmed the Commissioner's determination of a deficiency. The argument of the taxpayer that the cancellations were exempt gifts was answered by an opinion of the Board that, "No evidence was introduced to show a donative intent upon the part of any creditor. The evidence indicates, on the contrary, that the creditors acted for purely business reasons and did not forgive the debts for altruistic reasons or out of pure generosity."[4]

The court of appeals reversed the Board on the ground that the cancellations were not income but gifts, and the Supreme Court agreed.[5] Discussing section 22 (a), defining gross income for tax purposes, and section 22 (b) (3), de-

[1] 284 U. S. 1, 76 L. Ed. 131, 52 Sup. Ct. 4 (1931).

[2] For an excellent article setting out the exceptions in full see, LYNCH, *Some Tax Effects of Cancellation of Indebtedness*, 13 FORD. L. REV. 145 (1944).

[3] 318 U. S. 322, 87 L. Ed. 785, 63 Sup. Ct. 577 (1942).

[4] 44 B. T A. 425, 428 (1941).

[5] 128 F. 2d 254 (C. C. A. 7th 1942), 318 U. S. 322 (1942).

scribing the exclusion of gifts, bequests and devises,[6] the Court observed that the Treasury Regulation 94, relating to the Revenue Act of 1936, Art. 22 (a) -14, which covered cancellations of indebtedness, had made a change in the Treasury's concept of the tax effect of debt forgiveness. In the previous regulation the Treasury expressly recognized the situation where a creditor who desired to benefit his debtor canceled the debt without consideration, and it was held that the amount of the debt would be a gift not required to be included in the debtor's gross income. The new regulation, however, made no such express recognition of the "gift concept" of cancellation of indebtedness. In fact, it seemed to repudiate the idea by not only leaving it out of the new regulation, but also by expressly stating that, "A taxpayer realizes income by the payment or purchase of his obligations at less than their face value."[8] Although it seems that the regulation would have a direct bearing on the case, the Supreme Court merely observed that the Treasury's policies had changed, and went on into a discussion of cases related to the problem at hand. This discussion served to illustrate that the cases on the subject of cancellation of indebtedness were confusing and that legislation had been invoked in an effort to clarify the problem, but that none of this legislation was applicable to the case at hand. It was in this manner that the Supreme Court reached its decision that the case was to be governed by section 22 (b) (3) which exempts gifts from gross income. The word "gifts" was " a generic word of broad connotation, taking coloration from the context of the particular statute in which it may appear. Its plain meaning in its present setting denotes, it seems to us, the receipt of financial advantages gratuitously."[9]

The Court disagreed with the Board of Tax Appeals position that the cancellation of indebtedness, in this case, was not a gift. It was impressed by the fact that there was a personal relationship in the dealings between creditor and debtor in effecting these cancellations; and the fact that the motives were those of business or even selfish was not material. The release was a gratuitous forgiveness of debt—something from the creditor to the debtor for nothing—and sufficient to make the cancellations gifts within the meaning of the statute.

The only distinction between the *Dental* case and the *Kirby* case seems to be in the fact that in the former the parties did not deal in an "arms-length transaction," while in the latter the debt reduction was accomplished by transactions on the open market and not personally between the debtor and the creditor. With this in mind, along with the fact that in the *Dental* case the Court was of opinion that the motives leading a creditor to cancel his debtor's indebtedness were immaterial, it will be interesting to turn to a very recent case decided by the Supreme Court which was very similar on its facts to both the *Kirby* and the *Dental* cases.

Commissioner v. *Jacobson*, decided by the Supreme Court on January 17, 1949, involved the cancellation of indebtedness represented by mortgage bonds.[10] The taxpayer borrowed a sum of money from his bank to be used for the purchase of a building. He issued 200 bonds secured by a mortgage trust deed on the

[6] *Id.* at 325.
[7] *Id.* at 326 and n. 5.
[8] *Id.* at 326 and n. 4 [The current regulation which concerns this point is Treas. Reg. 111, sec. 29.22 (a)-17 (1949).]
[9] *Id.* at 330.
[10] 336 U. S. 28, 93 L. Ed. 297 69 Sup. Ct. 358 (1949).

property and the bonds were sold to various holders, the bank acting as trustee for the bond-holders. The bank failed on June 8, 1931 and a bondholder's committee was formed for the bondholders who had purchased bonds on taxpayer's building. Depression of real estate values caused the bond prices to drop. Although several extensions had been granted for the payment of the principal, the taxpayer had managed to pay the interest and retire some of the bonds as their due dates fell. At this time the petitioner decided to repurchase the bonds, at their depreciated values and succeeded in doing so, thereby cancelling his indebtedness for approximately half of what he had received for the bonds. The bonds were bought in two different ways: some were secured through direct negotiation with the owners of the bonds; while others were purchased indirectly through the secretary of the bondholders committee, and still others through the facilities of a bond broker, the taxpayer paying a commission to the broker on each sale.

The "gain" accomplished by virtue of the cancellation of indebtedness was denominated as income by the Commissioner and petitioner was charged with deficiencies in his income tax payments.

The Tax Court decided that the bonds repurchased through direct negotiations with the bondholders came directly within the rule laid down in the *Dental* case, due to the personal relationship involved, and therefore the increase in petitioner's assets from such dealings was a gift and non-taxable as income. As to those bonds repurchased indirectly, the Tax Court was of the opinion that the *Kirby* case rule would apply, because of the personal element thought necessary to make a gift within the meaning of the *Dental* case was absent.[11]

It is worth noting that six members of the Tax Court differed with the majority holding in this case. The majority had turned the case on the distinction between petitioner's dealings personally with the bondholders and his negotiations to purchase bonds through intermediaries. The dissent declared that this was error and that the proper criterion to distinguish the *Kirby* case from the *American Dental Co.* case was whether the acquisition of these bonds by petitioner at prices below their face value occurred under such circumstances that it might be said the forgiveness of the excess of the face value over the price paid was actually gratuitous and sufficient to make the cancellations in this case gifts within the statute. The dissent concluded that the cancellations, in this case, were not gifts, on the familiar contract theory that a part payment of a debt before it is due constitutes consideration which will support a promise of the creditor to waive or forgive the balance of the debt. Here the bonds were paid before their maturity dates, a fact which constituted the analogy utilized by the dissent in arriving at their determination that the cancellations were not gifts because given for valid consideration.[12]

On appeal to the court of appeals, the Tax Court decision was affirmed in part, and in part reversed.[13] As to the bonds purchased by the taxpayer directly from the bondholders, the court was of the view that such purchases came squarely within the rationale of the *Dental* case, and that the difference between the face

[11] 6 T. C. 1048 (1946).
[12] *Id.* at 1058.
[13] 164 F. 2d 594 (C. C. A. 7th 1947).

value of such bonds and the purchase price paid by the taxpayer did not represent taxable gain. The reversal in part, relating to the bonds purchased indirectly, was occasioned by a different view of the basis of the *Dental Co.* decision. The Court of Appeals was of the opinion that the personal relation of the parties in that case was not the important, or certainly not the controlling element. The turning point in that decision was, in the opinion of the court, that the creditors parted with their securities at less than their face value with *knowledge* that the amount received was in discharge of the debtor's obligation. Therefore, the court concluded, it is immaterial that the taxpayer, as to the purchase of some bonds, dealt with his creditors through an agent rather than in a face to face transaction, because the facts in the case were plain to show that in every sale the creditor knew that the agent with whom he dealt was purchasing the bonds for the debtor. In this, as well as direct negotiations, the objective sought and the results accomplished were held to be the same—a gratuitous forgiveness, and a release of something to the debtor for nothing.

The case was presented to the Supreme Court and it reviewed the facts and sustained the theory of the court of appeals that there could be no valid distinction between the sales made directly to the taxpayer and those made through agents, who the bondholders' knew were purchasing for the debtor.[14] However, the Supreme Court noted that the lower court had, without any finding of intent by the respective sellers to transfer or release something for nothing, as distinguished from an intent to get the highest available price for their claims, treated the taxpayer's gain as exempt from taxation because it felt itself obliged to classify each such gain as a "gift", and therefore non-taxable. Denominating this error, the Court reversed the decision. In justifying this action the Court used two arguments:

(1) The nature of the transactions in this case were not what would ordinarily indicate a gift from the creditor to the debtor of part of the indebtedness representative by the bonds. In other words the Court thought:

> "It is conceivable, althoug hardly likely, that a bondholder, in the ordinary course of business and without any express release of his debtor, might have sold part of his claims on the bonds he held at the full face value of those parts and then have made a gift of the rest of his claims on those bonds to the same debtor 'for nothing It is that kind of extraordinary transaction that the respondent asks us, as a matter of law, to read into the simple sales which actually took place and from which he derived financial gains."[15]

Therefore, on the factual basis, the Court held the gain not to be a gift, but income.

The *American Dental Co.* case was distinguished on the ground that a creditor would be "more likely" to transfer or release part of his claim for cash and the balance for nothing in connection with a release of an open account for rent or for interest, than he would in the sale of outstanding securities of a corporation or a private person.[16]

(2) The Supreme Court's second reason for not viewing these transactions as

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[14] See note 10 *supra.*

[15] 93 L. Ed. 297 309 (1949).

[16] *Ibid.*

gifts was founded upon a specific provision in the Revenue Act of May 28, 1938. The sections pertinent to the question in this case were 22 (a) and 22 (b).[17] The Court determined that the particular gains in question came within the definition of gross income as set out in 22 (a). The circuit court had also reached this conclusion, but had saved the taxpayer harmless from the tax by an additional finding that this specific gain was excluded from gross income by 22 (b) (3), which made the value of property acquired by gift not subject to the income tax. The Supreme Court held that such a result was not intended by the Congress, and in support of its position made an examination of section 22 (b) and its amendments. Section 22 (b) (9), a 1937 amendment to 22 (b), dealt with income from discharge of indebtedness represented by a security of a corporation, and provided, in substance, that where a corporation received income from the discharge of such indebtedness it could, upon certification to the Commissioner that the taxpayer was at the time of such discharge in an unsound financial condition, and if it would also agree to comply with the terms of section 113 (b) (3), such income would not be included in gross income. Section 113 (b) (3) required the taxpayer to apply the amount excluded from gross income under 22 (b) (9) to the reduction of the basis of any property held by the taxpayer during any portion of the taxable year in which such discharge occurred.[18]

The Court reasoned that if 22 (b) (3) was the proper section into which these cases of income from discharge of indebtedness should fall, as was advocated by the court of appeals, then there would be no need for this 22 (b) (9) amendment. Furthermore, as the status of corporations and natural persons is not differentiated in section 22 (a), the new amendments made it clear that inasmuch as they pertain to corporation *only* in this sort of case, it must be that natural persons in similar cases remain taxable under 22 (a). Another factor used by the court in its argument was that these amendments were only for a temporary period. This indicated to the court, that for its permanent program, Congress regarded such gains as properly taxable and that the amendments were intended to authorize temporary changes in policy, and were not clarifications of existing or continuing policies. The Court concluded that these amendments describe gains corresponding almost exactly with those derived by the respondent from his purchases in the instant case. The Court then observed that as the amendments pertained only to complying corporations, and not to natural persons, petitioner was not included within section 22 (b) (9) and therefore was subject to the tax under 22 (a).

This case, though similar on its facts to the *Dental Co.* case, reached a directly opposite result. Three Justices in the *Jacobson* case were of the opinion that the majority had done a poor job of distinguishing the *Dental Co.* case, and in effect, had overruled it.[19]

A comparison of the two decisions leads the writer to agree with the dissent. In the *Dental Co.* case the taxpayer was a corporation, and in the instant case Jacobson was a private individual. It is admitted that this would be an important distinction were both cases decided today because of the provisions of section

[17] 93 L. Ed. 297, 301 and n. 2 and 3.
[18] INT. REV. CODE sec. 22 (b) (9) and sec. 113 (b) (3); Revenue Act of 1939, sec. 215, 53 STAT. 862, 875, 876.
[19] 93 L. Ed. 297 309 (1949).

22 (b) (9) outlined above. However, when the *Dental Co.* case was decided section 22 (b) (9) had no application because its provisions were applicable only to taxable years beginning after December 31, 1938.[20] Therefore no distinction can be drawn between the two cases on that basis. Another difference might be drawn between the two cases on the ground that in the *Jacobson* case the debtor did not deal directly with the creditors in *all* cases, as was done in the *Dental Co.* case. The fallacy in this argument is that the majority of the Court itself conceded that there was no difference between personal contact in face-to-face transactions and in bargaining through agents, as long as the creditors had knowledge that the real buyer was his debtor. The last basis upon which a distinction might be drawn between the two cases is on the nature of the indebtedness involved in them. The Supreme Court seized upon this difference and held that in the *Jacobson* case the idea that a bondholder would agree to sell part of his bond and give the other part to the debtor was ridiculous; yet in the same set of facts, except for a bondholder there is substituted a noteholder, the court was emphatic in its opinion that the transaction amounted to a gift. That these two lines of reasoning are contradictory is shown by quotations from the two cases. In the *Dental Co.* case the Court supported the transaction of debt reduction as a gift by declaring: "The fact that the motives leading to the cancellation were those of business or even selfish, if it be true, is not significant. The forgiveness was gratuitous, a release of something to the debtor for nothing, and sufficient to make the cancellation here gifts within the statute."[21] The same court, speaking in the *Jacobson* case said, of the same question, "It is conceivable, although hardly likely, that a bondholder, might have sold part of his claims on the bonds he held at the full face value of those parts and then have made a gift of the rest of his claims on those bonds to the same debtor 'for nothing. It is that kind of extraordinary transaction that the respondent asks us, as a matter of law, to read into the simple sales which actually took place and from which he derived financial gains."[22]

Notice that in the first case the motives of the creditors were not significant, while in the latter case the motives of the creditor were the bases of the court's decision.

With this last possible distinction between the two cases invalidated, the conclusion is inevitable that the minority of the court was correct in its opinion that *Helvering* v. *American Dental Co.* has been overruled by *Commissioner* v. *Jacabson.*

A. SINGLETON CAGLE

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[20] 318 U. S. 322, 329 (1942).
[21] 318 U. S. 322, 331 (1942).
[22] 93 L. Ed. 297 309 (1949).